NANUBHAI DESAI & CO.

May 2010

# the RECKONER

keeping you AHEAD

## Contents

# INCOME TAX

## DOMESTIC TAXATION

### GENERAL

#### More income tax return forms notified

Close on the heels of notifying Saral-II (for salaried taxpayers), the Finance Ministry has now come out with the format of income-tax return forms for other categories of assessees. These new income-tax return forms would be valid for financial year 2009-10 (assessment year 2010-11).

The Central Board of Direct Taxes (CBDT) has come out with ITR-2, ITR-3, ITR-4, ITR-5, ITR-6, ITR-7 and ITR-V (electronic return) for AY 2010-11. The income-tax return forms notified for AY 2010-11 are more or less similar to the income-tax return forms notified for AY 2009-10. They do not have any material change as compared to earlier income-tax return forms (for assessment year 2009-10).

#### Central Board of Direct Taxes opens overseas offices

The Indian Central Board of Direct Taxes (CBDT) has opened offices in Singapore and Mauritius and plans to open in at least eight more countries in order to step up measures against tax evasion.

The offices would be attached to Indian missions "in order to facilitate exchange of information". The CBDT has decided to open 8 more offices in the US, the UK, the Netherlands, Japan, Cyprus, Germany, France and the United Arab Emirates.

Parliament has also been advised that the investigation directorate will monitor Indian visiting so-called 'tax haven' nations when it is suspected that they might have bank accounts there.

India's fight against tax avoidance and evasion has been strengthened by the negotiation of tax information exchange agreements with jurisdictions such as the Bahamas, Monaco, Panama, Seychelles, St Kitts & Nevis and the Maldives.

### Revised draft of DTC to be ready by June-end

The Government will finalize the revised draft of the Direct Taxes Code (DTC) by next month. It will then gather feedback from the public on the revised DTC,

aimed at simplifying the tax structure. It will be open for public viewing and comments for 15 days and then the final draft will be prepared.

While the Government came out with the first draft of DTC in August last year, it was supposed to be finalized by end of this month.

According to the Union revenue secretary, the draft DTC will be tabled during the monsoon session of Parliament and is likely to become a law by the next budget session.

## CIRCULARS

### Jeevan Akshay-VI approved for income-tax deduction

The Central Government have approved Jeevan Akshay-VI Plan of the Life Insurance Corporation of India as an annuity plan eligible for deduction under clause (xii) of sub-section (2) of section 80C of the Income Tax Act, 1961 ('the Act"). Persons who have invested in this plan during the financial year 2007-08 or subsequently (relevant assessment year being 2008-09 and subsequent assessment years) will be eligible for deduction of the amount invested from their total income chargeable to income tax. The benefit will, however, be limited to the overall ceiling limit of Rs.1,00,000 available for deduction under section 80C of the Act.

### Widening of existing road – definition of a new infrastructure facility

It has been decided by the Central Board of Direct Taxes ('CBDT') that widening of an existing road by constructing additional lanes as a part of a highway project by an undertaking would be regarded as a new "infrastructure facility" for the purpose of Section 80IA (4)(i) of the Act. However, relaying of an existing road would not be classifiable as a new infrastructure facility for this purpose.

### Industrial Park Scheme eligible for deduction under section 80IA of the Act extended to March 2011

Under the Industrial Park Scheme 2008, the undertaking notified under rule 18C of the Income Tax Rules, 1962, which begins to develop, develop and operate or maintain and operate an industrial park anytime during the period beginning the 1st April 2006 and ending on 31st March 2009, is entitled to the benefit of section 80IA(4)(iii) of the Act. The Finance Act (No.2) 2009 had extended the terminal date of the scheme from 31st March 2009 to 31st March 2011. Consequently, the CBDT has amended the Industrial Park Scheme 2008 and

Rule 18C of the Income Tax Rules, 1962 to give effect to the extension of the terminal date of operation of the Scheme.

**Section 197 of the Income-tax Act, 1961 – Deduction of tax at source**

***Certificate of lower deduction or non-deduction of tax at source***

Earlier it was laid down by CBDT that certificates for lower deduction or nil deduction of tax at source u/s 197 are not to be issued indiscriminately and for any such issue, prior approval of the concerned Range Head shall be obtained by the AO. Subsequently Instruction No. 7/2009, dated 23/12/2009, read with letter F.No.275/23/2007-IT (B) dated 8/02/2010, has laid down monetary limits for prior administrative approval of the CIT-TDS or DIT-Intl. Taxation, as the case may be.

Now, as per new direction by CBDT dated 25th May, 2010, the certificates u/s 197 shall be generated and issued by the AO mandatorily through ITD system only. It has been also clarified by CBDT that in case, due to certain reasons, it is not possible to generate the certificate through the system on the date of its issue, the AO shall upload the necessary data on the system within 7 days of the date of issue (manually) of the certificate. The Prior administrative approval by the Range Head and by the CIT-TDS / DIT-Intl is required in both the cases.

**Amendments in Income-tax Rules with regard to tax deduction/ collection at source provisions**

**Background**

The Central Board of Direct Taxes (CBDT) has amended the Income tax Rules, 1962 ('the Rules') by notifying Income-tax (6th Amendment) Rules, 2010 in respect of the tax deduction at source (TDS)/ tax collection at source (TCS) provisions and compliance requirements (furnishing of quarterly statements, issue of certificates, etc.)

The new rules shall apply in respect of TDS/ TCS on or after from 1 April 2010. The key features of the new rules in respect of TDS/ TCS other than by Government authorities have been summarized in the following pages:

**The new Rules in relation to TDS on salary payment:**

| Particulars | Rule No. | Income-tax Rules effective 1 April 2010 |
|---|---|---|
| Deposit of TDS | 30(2)(a) | On or before 30 April if the amount is credited/ paid in the month of March. |

| Particulars | Rule No. | Income-tax Rules effective 1 April 2010 |
|---|---|---|
| | 30(2)(b) | In any other case, on or before 7 days from the end of the month in which tax deducted/ income-tax due u/s 192(1A). |
| Quarterly deposit of TDS | 30(3) | On 7 July, 7 October, 7 January for the first three quarters and 30 April following the last quarter of the relevant financial year, if the Assessing Officer permits in special cases with the prior approval of Joint Commissioner. |
| Mode of deposit of TDS:<br>- by a Company/ specified person | 30(6)/ (7) | Deposit of TDS electronically (accompanied by electronic income-tax challan) with Reserve Bank of India (RBI) or State Bank of India (SBI) or any authorized bank, by way of:<br>(a) internet banking facility; or<br>(b) debit card. |
| - by any other deductors | 30(6) | Deposit of TDS (accompanied by an income-tax challan) with RBI or SBI or any authorized bank. |
| Issue of annual TDS/ salary certificate in Form No.16 | 31(1)/ (2)/(3) | Form No. 16 shall be issued to the employee by 31st May of the financial year following the relevant financial year. The said Form shall specify the following:<br>a) Permanent Account Number (PAN) of the employee<br>b) Tax deduction Account Number (TAN) of the employer<br>c) Challan Identification Number(s)4 (CIN)<br>d) Receipt numbers of all the quarterly statements (Form 24Q) of the relevant financial year |
| Use of Digital Signatures in Form No. 16 | 31(6) | The employer, at his option, may use Digital Signatures to authenticate Form No. 16 issued to employee, subject to the following:<br>a) The Form shall specify the relevant details as stated above. |

| Particulars | Rule No. | Income-tax Rules effective 1 April 2010 |
|---|---|---|
| | | b) After signatures, the contents cannot be changed<br>c) The Form has a control number |
| More than one employer during the year | 31(4) | If the employee is employed by more than one employer during the financial year, each of the employers shall issue Part A of the Certificate in Form No. 16 pertaining to the respective period for such employee was employed.<br><br>Part B may be issued by each of the employer or the last employer, at the option of the employee. |
| Furnishing of quarterly TDS statement in Form No.24Q | 31A(1)/ (2) | Form No. 24Q shall be furnished by 15 July, 15 October and 15 January for first three quarters respectively and 15 May following the last quarter of the relevant financial year. |
| Manner of furnishing Form No. 24Q | 31A(3)/ (4) | • The Form 24Q may be furnished in any of the following manners:<br>a) in paper form<br>b) Electronically as per prescribed procedure/ format along with verification of the statement in Form 27A<br>• In case of company/ specified person/ number of<br>deductee's in any quarterly statement are 20 or more shall furnish Form 24Q electronically only.<br><br>• In Form 24Q, the employer shall specify the following:<br><br>(a) TAN of the employer<br>(b) PAN of the employer<br>(c) PAN of all the employees<br>(d) Particulars of tax deposit including CIN |

**The new Rules in relation to TDS on payments other than salary:**

| Particulars | Rule No. | Income-tax Rules effective 1 April 2010 |
|---|---|---|
| Deposit of TDS | 30(2) | Similar provisions as applicable to TDS on salary payment |
| Quarterly deposit of TDS under specified sections | 30(3) | Similar provisions as applicable to TDS on salary payment |
| Mode of deposit of TDS | 30(6) | Similar provisions as applicable to TDS on salary payment |
| Mode of deposit of TDS by a Company/ specified person | 30(6)/ (7) | Similar provisions as applicable to TDS on salary payment |
| Issue of Quarterly TDS certificate in Form No.16A | 31(1)/ (2)/ (3) | Form No. 16A shall be issued to the deductee on a quarterly basis within 15 days for the due date of furnishing quarterly TDS statement (Form 26Q/ Form 27Q).<br><br>The said Form shall specify the following:<br>(a) PAN of the deductee<br>(b) TAN of the deductor<br>(c) CIN<br>(d) Receipt numbers of all the relevant quarterly statements (Form 26Q/ Form 27Q) of the relevant financial year. |
| Particulars | Rule No. | Income-tax Rules effective 1 April 2010 |
| Furnishing of quarterly TDS statement in Form No.27Q/ Form 26Q | 31A(1)/ (2) | Similar provisions as applicable to TDS on salary payment |

| Particulars | Rule No. | Income-tax Rules effective 1 April 2010 |
|---|---|---|
| Manner of furnishing Form No. 26Q/ Form 27Q | 31A(3)/ (4) | Similar provisions as applicable to TDS on salary payment |

**The new Rules in relation to tax collected at source:**

| Particulars | Rule No. | Income-tax Rules effective 1 April 2010 |
|---|---|---|
| Deposit of TCS | 37CA(2) | Within one week from the end of the month in which collection is made. |
| Modes of deposit of TCS | 37CA(5) | Similar provisions as applicable to TDS payments |
| Mode of deposit of TDS by a Company/specified person | 37CA(5)/ (6) | Similar provisions as applicable to TDS payments |
| Issue of TCS Certificate in Form No.27D | 37D(1)/(2)/ (3) | Form No. 27D shall be issued to the collectee within 15 days from the due date for furnishing the TCS statement (Form No. 27EQ). The said Form shall specify the following:<br>(a) PAN of the collectee<br>(b) Tax Collection Number of the collector<br>(c) CIN<br>(d) Receipt/ acknowledgment numbers of all the quarterly statements (Form 27EQ) of the relevant financial year. |
| Furnishing of TCS Statement in Form No.27EQ | 31AA(1)/ (2) | Similar provisions as applicable to TDS payments |

| Particulars | Rule No. | Income-tax Rules effective 1 April 2010 |
|---|---|---|
| Manner of furnishing Form No. Form 27EQ | 31AA(3)/ (4) | Similar provisions as applicable to TDS payments |

**Summary:**

The new Rules have amended the due date for issuing the TDS certificates to employees in Form 16 (for salary payments) from 30th April to 31st May following the end of relevant financial year and to deductees in Form 16A (for payments other than salary) on a quarterly basis (vis-à-vis the existing flexibility of issuing the same on an annual basis as well.). The TDS certificate Forms have been consequently amended.

Additionally, the due date for furnishing the quarterly statement (Form 24Q/ Form 26Q/ Form 27Q) for the last quarter of the relevant financial year has been amended from 15th June to 15th May following the end of such quarter.

The new rules are effective for tax deducted/ collected at source on or after 1 April 2010. Any tax deducted/ collected at source before the said date will be governed by the provisions existing before these amendments.

As per the press release by the CBDT, the TAN of the deductor, PAN of the deductee, and receipt number of TDS statement filed by the deductor will form the unique identification for allowing credit of taxes claimed by the taxpayer in his income-tax return.

## CASE LAWS

### ACIT vs. Mahindra Holidays & Resorts (India) Limited (ITAT Chennai Special Bench)

**Timeshare membership fee is taxable only over the term of contract**

The assessee company is in the business of selling timeshare units in its various resorts. For the assessment year 1998-99 the assessee declared a total loss of Rs.3,90,42,370/-. The Assessing Officer had determined a loss at Rs.1,87,58,252/- by an order under section 143(3) of the Act. Subsequently, the assessment was reopened under section 147 of the Act. It was noticed by the AO that the relevant balance sheet showed an amount of Rs.14,98,30,966/- under the heading “Deferred income – advance towards members facilities – see

note 1(vi)(a)". This figure represented the amount collected from timeshare members but not recognized as revenue for the current year. The explanation of the assessee was that it had considered only 40% of the membership fees collected as income and the balance 60% was treated as deferred income.

The assessee, having resorts at tourist places, granted membership for a period of 33/25 years on payment of certain amount. During the currency of the membership, the member had the right to holiday for one week in a year at the place of his choice from amongst the resorts of the assessee. The membership fee was received either in lump sum or in instalments from the prospective members. In addition to the membership fee, the member was liable to pay maintenance charges or subscription fees irrespective of whether he made use of the resort or not. If the resort was utilized, additional payment towards utilities like electricity, water, etc was payable. Though the assessee was following the mercantile system of accounting and treated the membership fee as revenue receipt, only 40% of the amount received was offered for taxation in the year of receipt. The balance was equally spread over the period of membership of 25 or 33 years on the ground that it was relatable to the services to be offered to the members.

The AO took the view that as per the accrual system of accounting, the entire receipt had to be assessed as income in the year of receipt. The CIT (A) upheld the stand of the assessee.

**Decision of Chennai Special Bench**

On appeal by the Department, the matter was referred to the Special Bench. The Special Bench had dismissed the appeals of the Department and held that

- In the case of E.D. Sassoon & Co. Ltd. v. CIT (26 ITR 27), Hon'ble Supreme Court held that two conditions necessary for income to have "accrued to" or "earned by" an assessee are
  (i) the assessee has contributed to its accruing or arising by rendering services or otherwise, and
  (ii) a debt has come into existence and he must have acquired a right to receive the payment.
  In the present case, though a debt is created in favour of the assessee immediately on execution of the agreement, the assessee has a continuing obligation to provide accommodation to the members for one week every year till the currency of the membership. Till the assessee fulfils its promise, income could not accrue to it.

- The argument of the assessee that the balance amount of membership fees has to be spread over the tenure of membership, on the ground that heavy expenditure for the upkeep and maintenance of the resorts has to

be incurred, is not acceptable because separate charges are collected for maintenance and use of utilities and therefore the matching concept cannot be pressed into service with regard to the membership fee.

- Recognizing the entire receipt as income in the year of receipt can lead to distortion. Following the principles laid down in the decision of Madras Industrial Investment Corporation (225 ITR 802 (SC)), where it was held that allowing the entire expenditure in one year might give a distorted picture of the profits of a particular year, recognizing the entire receipt in one year can also lead to distortion.

- Consequently, the entire amount of timeshare membership fee receivable by the assessee up front at the time of enrolment of a member is not chargeable to tax in the initial year on account of contractual obligation that is fastened to the receipt to provide services in future over the term of contract.

**Management Structure & Systems Pvt Ltd vs. ITO (ITAT Mumbai)**

**Tests lay down to determine whether income from shares is "business" income or "capital gains"**

The assessee company is engaged in the Management Consultancy, Investment Advisory and Equity Reserve Research Services and also dealing in the Investments. The assessee filed the Return of Income, declaring total income of Rs.1,03,21,714. The assessee had declared the capital gain of Rs. 103,21,714/- as under

| | |
|---|---|
| Long Term Capital Gain | Rs. 99,11,474 |
| Short Term Capital Gain | Rs. 19,82,900 |
| **Total** | **Rs.1,03,21,714** |

The Assessing Officer was not in favour of accepting the computation of capital gains as declared by the assessee, since in his opinion, the assessee's activity in shares was a business activity. It was stated by the assessee that it is not carrying on any trading in equity shares. It invests in shares and holds such shares as an investment and not as stock-in-trade. The shares are held for the purpose of earning the dividend and for the purpose of investments in shares. The funds for investment in shares are never borrowed and own funds are utilized. The AO did not agree with the explanation of the assessee. The AO noted that the main object of the company was a Management Consultancy and incidental object of the assessee company was to make investment. During the assessment year under consideration and as well as in preceding five years, the main activity of the assessee was trading in shares which had resulted in Short

Term Capital Gain and Long Term Capital Gain, but in respect of the main activity, that was 'Management Consultancy', the contribution to the gross income was very small. The AO further noted that the assessee was regularly dealing in the shares through out the year and hence, he was dealer in shares in respect of all sales. The assessee was regularly buying and selling the securities/shares and that suggests that the profit motive was the main object for purchasing of the shares. In the opinion of the AO, all the fundamental characteristics for treating/holding the shares as an investment were lacking. The AO was of the view that the entire transactions in the shares were made with the profit motive. Deploying own surplus funds, in the securities which are likely to appreciate suggests the assessee's business interest.

In respect of accepting the assessee's trade as an investment in preceding years, the AO noted that merely because the assessee's plea had been accepted earlier, that would not preclude the AO from recording the finding different from that of an earlier year. The AO referred and relied on plethora of the decisions of the Hon'ble Supreme Court as well as of the different High Courts, as also referred to the Accounting Standards as prescribed by the Institute of Chartered Accountants of India and finally held that the profit/gain earned from dealing in the shares was a business income and accordingly the income of Rs.1,03,21,714/- had been taxed as "Profits & Gains of Business".

The assessee carried the issue before the Ld CIT(A) but without success.

**Decision of Mumbai Tribunal**

As the Ld CIT(A) had confirmed the assessment order, the assessee had preferred an appeal before the Tribunal. The Tribunal had directed the AO to accept the capital gains declared by the assessee from the sale of the shares. Accordingly, it was held that though there was no fixed formula to determine whether the activity of purchasing and selling shares could be treated as a trading activity or as investment activity, certain guiding principles have been laid down in CBDT's Circular No. 4/2007 dated 15.6.2007 as well as in the ruling in case of Gopal Purohit (122 TTJ 87 (Mum)) (affirmed in 228 CTR 582 (Bom)), in case of Saranath Infrastructure (120 TTJ 216 (Luck)) and other judgements. These principles of law have to be applied to the following facts:

- As per the books of account, the assessee has treated the entire investment in shares as an "investment" and not as "stock-in-trade";
- The assessee was not a share broker nor it was having a registration with any Stock Exchange;
- Almost 83% of the capital gain was from shares that were held for a long period of time;

- There were no derivative transactions by the assessee;
- There were no transactions without delivery;
- The assessee used his own surplus funds for investing in shares and not borrowed any money;
- In the preceding years, the assessee consistently declared the gain/profit on the sale of the shares as 'Capital Gains' and the same had been accepted by the AO. Though the rule of res judicata is not applicable to income-tax proceedings, in the absence of change in facts, there should be consistency in the approach of the Revenue;
- The assessee received substantial dividend on the investments.

Thus, it was held that the entire income from the sale and purchase of the shares was to be assessed under the head 'capital gain' as rightly declared by the assessee either Long Term Capital Gain (LTCG) or Short Term Capital gain (STCG) depending upon the period of holding.

**JCIT vs. Saheli Leasing & Industries (Supreme Court)**

**Penalty u/s 271(1)(c) is leviable even if the assessment is at a loss. – Supreme Court chides High Court for "casual" order.**

The assessee had filed its return declaring total income of Rs. Nil after claiming depreciation. The Assessing Officer disallowed depreciation but still assessed the total income at Rs. Nil. Penalty u/s 271(1)(c) was levied on the disallowance. Penalty was sought to be imposed in respect of an item having an effect in reducing the loss. No appeal was filed by the assessee against the item added to the income on account of which the loss was reduced. The assessee stated to the AO that even after disallowance of the said depreciation, the taxable income of the assessee was Nil and hence, there was no tax liability. According to the assessee, in such a case no penalty under Section 271 (1)(c) could have been levied. With reference to explanation 4 (a) to Section 271 (1) (c) of the Act, a penalty of Rs. 11,14,364/- was imposed on the Assessee. CIT (A) had dismissed the appeal of the aggrieved assessee and confirmed the penalty levied by AO. Assessee preferred further appeal before the Income-Tax Appellate Tribunal, Ahmedabad. The Tribunal, on the strength of an earlier order passed by Special Bench of Ahmedabad Tribunal in the case of Apsara Processors (P) Ltd. and Ors. in ITA No. 284/Ahd./2004, came to the conclusion

that no penalty can be levied, if both, viz. the returned income and the assessed income resulted into loss.

**Decision of the High Court**

The department filed an appeal before the High Court. The High Court had dismissed the appeal of the department on the basis that no penalty u/s 271(1)(c) could be levied.

**Decision of Supreme Court**

Aggrieved by the order of High Court, the department had preferred an appeal before the Supreme Court. The Supreme Court allowed the appeal of the department and directed that the Revenue would be at liberty to proceed further against the assessee on merits in accordance with law.

The department contended before the Supreme Court that the point projected in this appeal stands answered in favour of the Revenue by a judgment of Bench of three learned Judges of the Supreme Court in the decision in the case of CIT Vs. Gold Coin Health (P) Ltd. 304 ITR 308 (SC) which has overruled an earlier judgment of Supreme Court in the case of Virtual Soft Systems Ltd. Vs. CIT 289 ITR 83 (SC) pronounced by two learned Judges.

It was held by the Supreme Court that:

- The High Court has dealt with the appeal in a most casual manner and further stated that the order of the High Court was not only cryptic but did not even remotely deal with the arguments projected by the Revenue before it. The Supreme Court also stated that it is unfortunate that the guidelines issued by the Supreme Court from time to time as to how judgments/orders are to be written are not being adhered to in this order. The Supreme Court stated that it is true that brevity is an art but brevity without clarity is likely to enter into the realm of absurdity, which is impermissible.

- The Supreme Court stated that the matter of decision in the case of CIT Vs. Gold Coin Health (P) Ltd. 304 ITR 308 (SC) was placed before three learned judges of Supreme Court, as correctness and propriety of the order passed by two learned judges of Supreme Court in the decision in the case of Virtual Soft Systems Ltd. Vs. CIT 289 ITR 83 SC was doubted and to clear the doubts, on the correct exposition of law, a three Judge Bench was constituted which decided the matter in Gold Coin (supra).

- The Supreme Court observed that it is to be seen that purpose behind Section 271 (1)(c) of the Act is to penalize the Assessee for –

    a) concealing particulars of income and / or
    b) furnishing inadequate particulars of such income.

- The Supreme Court stated that whether income returned was a profit or loss was really of no consequence. Therefore, even if no tax was payable, the penalty was still leviable. The Supreme Court further stated that it is to be noted that even prior to the amendment, it could not be read to mean that if no tax was payable by the Assessee, due to filing of return, disclosing loss, the Assessee was not liable to pay penalty even if the Assessee had concealed and/or furnished inadequate particulars.

- The Supreme Court stated that some of the High Courts had taken a contrary view so the Parliament clarified the position by changing the expression "any" by "if any". The Supreme Court further stated that this was not a substantive amendment which created imposition of penalty for the first time. The Supreme Court observed that the amendment by the Finance Act of the relevant year, as specifically noted in the note on clauses, shows that proposed amendment was clarificatory in nature and would apply to all assessments even prior to the assessment year 2003-2004.

- The Supreme Court further stated that in the decision of CIT Vs. Gold Coin Health (P) Ltd. (304 ITR 308 (SC)), after combined reading of the recommendations of Wanchoo Committee and Circular No. 204 dated 24.7.1976, it was clarified that points had been made clear with regard to Explanation 4 (a) to Section 271 (1) (c) (iii) to intend to levy penalty not only in a case where after addition of concealed income, a loss returned, after assessment becomes positive income, but also in a case where addition of concealed income reduces the returned loss and finally the assessed income is also a loss or minus figure. The Supreme Court further stated that therefore, even during the period between 1.4.1976 and 1.4.2003, the position was that penalty was still leviable in a case where addition of concealed income reduces the returned loss.

- The Supreme Court further observed that in the aforesaid case, the expression "income" in the statute appearing in Section 2 (24) of the Act has been clarified to mean that it is an inclusive definition and includes losses, that is, negative profit. This has been held so on the strength of earlier judgments of the Supreme Court in the case of CIT Vs. Harprasad and Co. P. Ltd ((1975) 99 ITR 118) and followed in the decision in the case of Reliance Jute and Industries Ltd. Vs. CIT ((1979) 120 ITR 921).

After elaborate and detailed discussion, Supreme Court held with reference to the charging provisions of statute that the expression "income" should be understood to include losses. The expression "profits and gains" refers to positive income whereas "losses" represent negative profit or in other words minus income.

- The Supreme Court further stated that considering this aspect of the matter in greater details, decision in the case of CIT Vs. Gold Coin Health (P) Ltd. (304 ITR 308 (SC)) over-ruled the view expressed by two learned judges in the decision of the Virtual Soft Systems (289 ITR 83 SC).

- The Supreme Court further stated that on deeper scanning of the decisions in the case of CIT Vs. Gold Coin Health (P) Ltd. (304 ITR 308 (SC)) and Elphinstone Spinning and Weaving Mills Co. Ltd. (XL ITR 142), it is to be concluded that the ratio decidendi of Gold Coin (supra) fully covers the issue and Elphinstone (supra) has no application to the facts of the said case.

- The Supreme Court examined decisions of both the above cases and noted that:

  a) Gold Coin Health (supra) arose under the Income Tax Act, 1961, whereas Elphinstone (supra) arose under the repealed Income Tax Act of 1922.

  b) The question that was considered in Gold Coin (supra) was what would be the true interpretation of Section 271 (1) (c) in the context of amendments made therein whereas, the question in Elphinstone (supra) was in relation to chargeability of "additional tax" on "dividend income" earned by Assessee under paragraph – B of First Schedule to the Income Tax Act, 1922.

  c) Elphinstone (supra) interpreted five words occurring in para-B of First Schedule namely; "additional", "additional Income Tax", "charge on the total income", "profits liable to tax" and lastly, "dividends payable out of such profits", whereas, in Gold Coin's case, the question arose whether word "income" includes loss for the purpose of imposition of penalty u/s 271 (1) (c) and if Assessee incurs loss in any particular year then whether penalty u/s 271 (1) (c) can still be imposed on him. The Supreme Court stated that this has been categorically answered in Gold Coin (supra) in favour of Revenue and against the Assessee.

d) The object of imposing penalty is different from determining Assessee's liability to pay tax or additional tax under any charging section. The Supreme Court further noted that the interpretation applied to penalty provision cannot be applied while interpreting any charging section for payment of income tax or additional tax. Both provisions i.e. penalty and charging have different objects and consequences and they operate in different fields qua Assessee.

e) A particular word occurring in one Section of the Act, having a particular object cannot carry the same meaning when used in different Section of the same Act, which is enacted for different object. The Supreme Court further noted that one word occurring in different Sections of the Act can have different meaning, if the object of the two sections is different and when both operate in different fields.

- The Supreme Court stated that question of law involved in this appeal is directly covered by the decision of Gold Coin (supra) and is to be answered accordingly. The Supreme Court further stated that Elphinstone (supra) has no bearing over the view taken in Gold Coin (supra) case and even if it had been taken note of, the decision taken therein would have been the same due to aforementioned distinguishing feature.

- The Supreme Court held that on merits, in view of the decision in case of CIT vs. Gold Coin Health (304 ITR 308 (SC)) (which overruled the decision in case of Virtual Soft Systems 289 ITR 83 SC), penalty u/s 271(1)(c) is leviable even if the assessment is at a loss.

## INTERNATIONAL TAXATION

### CASE LAWS

**The Prudential Assurance Company vs. DIT (Bombay High Court)**

**AAR rulings are binding despite contrary rulings of AAR. Assessment order following binding precedent is not amenable to section 263 revision**

**Facts of the case:**

The assessee, a FII based in UK, applied for an advance ruling on whether the profits arising to it from purchase and sale of Indian securities was “business profits” and whether in the absence of a ‘Permanent Establishment’ in India, the

said profits were chargeable to tax under the India-UK DTAA. The AAR issued a ruling dated 30.4.2001 holding that the profits were "business profits" and that they were not chargeable to tax in India in the absence of a PE. Subsequently, the AAR took the contrary view in the case of Fidelity Northstar Fund (288 ITR 641) decision that as a FII was prevented by SEBI regulations from trading in shares, the profits arising to it was assessable as "capital gains" and not "business profits". Based on the said ruling in the case of Fidelity Northstar Fund, the DIT issued a notice u/s 263 in which the view was taken that the subsequent ruling of the AAR was a "change in law" and the ruling obtained by the assessee was no longer "binding" u/s 245S (2) and that the assessment orders passed on the basis of the ruling were "erroneous and prejudicial to the interests of the revenue". The assessee filed a writ petition to challenge the said notice.

**Legal analysis:**

Section 245S stipulates that an advance ruling is binding on the applicant, the CIT and the authorities subordinate to him in relation to which it was sought. Section 245S (2) claims that the ruling shall cease to be binding if there is a change in law or facts on the basis of which the advance ruling has been pronounced. Once a ruling has been pronounced by the Authority, its' binding effect can only be displaced in accordance with the procedure stipulated in law.

The CIT clearly exceeded his jurisdiction in relying upon the ruling of the AAR in the case of Fidelity Northstar Fund as a basis to hold that the ruling obtained by the assessee was not binding on the department. The CIT ignored the clear mandate of the statutory provision that a ruling was binding only on the Applicant and the Revenue in relation to the transaction for which it is sought. The ruling in the case of Fidelity Northstar Fund cannot possibly, as a matter of the plain intendment and meaning of section 245S, displace the binding character of the advance ruling rendered between the assessee and the Revenue.

**Decision by Bombay High Court:**

For the aforesaid reasons, it was held by the Court that on both counts the invocation by the Commissioner of the jurisdiction under Section 263 was improper. Firstly, the Commissioner has made a determination contrary to the plain language of Section 245S when he holds that the ruling of the AAR in the case of Fidelity Northstar Fund would apply to the case of the assessee. Unless the binding ruling in the case of the petitioner is displaced by pursuing requisite procedures under the law, that ruling must continue to operate and be binding between the petitioner and the Revenue. Secondly, and in any event, the Commissioner could not have possibly come to the conclusion that the view of the Assessing Officer was erroneous or that it was prejudicial to the interests of the Revenue when the Assessing Officer has followed a binding ruling of the

AAR. The assessment order which gives effect to a binding precedent, in this case of the AAR, cannot be regarded as being erroneous or as being prejudicial to the interests of the Revenue. Since the invocation of the jurisdiction was not proper, the petitioners should not be relegated to pursue the proceedings initiated under Section 263.

**Ashapura Minichem Ltd. vs. ADIT (ITAT Mumbai)**

**Fees for Technical Services, even if rendered outside India, are taxable**

**Facts of the case:**

Ashapura Minichem Limited ("AML"), an Indian company, entered into an agreement with a Chinese company, viz. China Aluminium International Engineering Corp Ltd. ("CAIECL"), under which AML was to pay CAIECL US $ 1mn for bauxite testing services. Such services were to be carried out by CAIECL in its laboratories at China.

At the time of making remittance of US$ 1mn for the bauxite testing services to CAIECL, AML filed an application as provided under section 195 of Income Tax Act to Assistant Director of Income Tax (International Taxation), inter alia, requesting him to certify and declare that no tax was required to be withheld from the aforesaid remittance.

AML contended that CAIECL should be taxed in accordance with the provisions of India-China Tax Treaty. The tax treaty, being beneficial to the assessee, would override the provisions of the Income Tax Act, 1961 (the 'Act'). Receipts on account of bauxite testing services could be taxed in India only if CAIECL had a Permanent Establishment (PE) in India. Since CAIECL did not have PE in India, business profits of CAIECL should not be taxed in India. Thus, no taxes were required to be withheld from the remittance to the said company.

AML contended that since no part of the testing services was rendered in India, the CAIECL did not have any tax liability in India and hence there was no withholding tax obligation in this case.

The Assessing Officer (the 'AO') held that the services rendered by CAIECL were in the nature of 'Fees for Technical Services' covered under Article 12 of the India-China Tax Treaty, as also under section 9 (1) (vii) of the Indian Income Tax Act, 1961. The AO concluded that in terms of the treaty provisions, AML was to withhold tax @10% of the gross amount of remittance to CAIECL.

AML was aggrieved and went into further appeal before ITAT.

**Taxability of Fees under the Act:**

**Contentions of the assessee:**

The assessee contended that since no part of the testing services was rendered in India, the Chinese company did not have any tax liability in India in respect of the bauxite testing charges. The assessee further contended that in order to attract taxability under section 9 (1)(vii) of the Income Tax Act, 1961, not only that the services should be utilized in India, but should also be rendered in India. The assessee relied on the Supreme Court judgement laid down in the case of Ishikawajima Harima Heavy Industries Ltd. vs. DIT (288 ITR 408) and on the High Court's judgment in the case of Clifford Chance Vs DCIT (318 ITR 297).

**Contentions of the department:**

The department contended that, in case it proceeds on the basis that the royalties or fees for technical services can be taxed in India only when the services are utilized as well as rendered in India, the source rule will cease to have any meaning. The department further contended that the judgments in the case of Ishikawajima and Clifford Chance are clearly contrary to the legislative intent and the doubts, if any, have been set at rest by the retrospective amendment to Explanation to Section 9(1)(vii), as introduced by the Finance Act, 2010. The department also contended that once the proposed amendments are carried out, these judicial precedents will no longer constitute good law.

**Legal Analysis and Decision of the ITAT:**

**a) Analysis of Section 9 (1) (vii) and interplay with section 5:**

- With regard to taxability under the domestic law, the ITAT observed that section 9(1)(vii) provides that " income by way of fees for technical services payable by a person who is a resident, except where the fees are payable in respect of services utilized in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India" will be deemed to accrue or arise in India. The ITAT further stated that there is no dispute that the fees received by the assessee is covered under 'fees for technical services' under Explanation 2 to Section 9(1)(vii) and also there is no dispute that the exclusion clause set out in the said definition is not attracted.

- The ITAT stated that the case of the assessee, however, is that since the services are not rendered in India, the provisions of Section 9(1)(vii) cannot be invoked. The ITAT further stated that the main support for this proposition is assessee's reliance on the judgment in the case of Clifford Chance.

- The ITAT further stated that as per the observation in the decision of Ishikawajima, section 9(1)(vii) of the Act must be read with section 5 thereof, which takes within its purview the territorial nexus on the basis whereof tax is required to be levied, namely, (a) resident; and (b) receipt of accrual of income. The ITAT further stated that as per the above mentioned decision, the interpretation with reference to the nexus to tax territories assumes significance. The ITAT also stated that territorial nexus for the purpose of determining the tax liability is an internationally accepted principle.

- The ITAT further observed that having regard to the internationally accepted principle and the DTAA, no extended meaning can be given to the words "income deemed to accrue or arise in India" as expressed in section 9 of the Act. The ITAT further stated that section 9 incorporates various heads of income on which tax is sought to be levied by the Republic of India. The ITAT held that whatever is payable by a resident to a non-resident by way of fees for services, thus, would not always come within the purview of section 9(1)(vii) of the Act. The ITAT further stated that it must have sufficient territorial nexus with India so as to furnish a basis for imposition of tax.

- ITAT further stated that based on the understanding of law laid down in the case of Ishikawajima, it is evident that section 9(1)(vii)(c), read in its plain language, envisages the fulfillment of two conditions : services, which are source of income sought to be taxed in India must be (i) utilized in India, and (ii) rendered in India.

**b) Analysis of Retrospective Amendments and its consequences :**

- The ITAT stated that the legal proposition canvassed by the assessee, however, no longer holds good in view of retrospective amendment w.e.f. 1st June 1976 to Explanation to Section 9(1) brought out by the Finance Act, 2010. The ITAT further stated that under the amended Explanation to Section 9(1), as it exists on the statute now, it is specifically stated that the income of the non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of section 9(1), and shall be included in his total income, whether or not (a) the non-resident has a residence or place of business or business connection in India; or (b) the non-resident has rendered services in India. The ITAT further stated that it is thus no longer necessary that, in order to attract taxability in India, the services

must also be rendered in India. The ITAT also stated that as the law stands now, utilization of these services in India is enough to attract its taxability in India. The ITAT further stated that to that effect, recent amendment in the statute has virtually negated the judicial precedents supporting the proposition that rendition of services in India is a sine qua non for its taxability in India.

**c) Decision of the ITAT:**

- The ITAT ruled that the judgment in the case of Ishikawajima and Clifford Chance is no longer good law, as a result of above mentioned amendments. Thus, it is no longer necessary that, in order to invite taxability under section 9(1)(vii) of the Act, the services must be rendered in the Indian tax jurisdiction. Therefore, the income of the CAIECL, by way of receipt of fees for technical services from an Indian company, is to be deemed to accrue or arise in India under Section 9(1)(vii) of the Act. The ITAT held that it is accordingly liable to be taxed in India under the domestic tax law.

**Taxability of Fees under the Treaty:**

**Contentions of the assessee:**

**a) India - China Tax Treaty:**

The assessee contended that in terms of the provisions of Article 12 of the India-China Tax Treaty, taxability of royalties can only arise when the services are used and rendered in India. The assessee further contended that the only other situation in which such receipts can be taxed in India is under Article 7 of the applicable tax treaty provisions - when the said income is earned in the course of business carried on by the assessee in India through a permanent establishment in India. The assessee further contended that CAIECL did not have any PE in India and therefore, the business profits of CAIECL cannot be taxed under Article 7 of the tax treaty. The assessee also contended that Article 12 cannot be applied on the facts of the present case, because no part of the services rendered by the resident of China is rendered in India. Thus the testing services could not be brought to tax in India in terms of provisions of Article 12 of the tax treaty.

**b) Source rule principle under treaties by India / China:**

The assessee further contended that, unlike the provisions in most other tax treaties, the taxability of fees for technical services in the India-China

Tax Treaty has an additional requirement of 'place of performance' in the source country, to be satisfied before it can be taxed as fees for technical services in the source country. The assessee in this regard referred to the provisions of India-China Tax Treaty, China-Pakistan Tax Convention, India-Israel Tax Convention, India-South Africa Tax Convention and India-Germany Tax Convention.

**c) Treaty treatment with India/China:**

- The assessee further contended that the India-China Tax Treaty is unique in its wordings and its scope – so far as the taxability of fees for technical services is concerned. The assessee also contended that 'fees for technical services', for the purpose of Article 12 (6), cannot have any other meaning than the meaning assigned under Article 12(4) and under article 12(4), place of performance test is to be satisfied before 'fees for technical services' can be taxed in the source state. The assessee repeatedly emphasized that Article 12 (6) can come into play only when the 'fees for technical services' meets the definition assigned to the said term under Article 12 (4) and since 'place of performance test' must be met in order to meet the definition under Article 12(4), unless the services are rendered in the other Contracting State, the same cannot be covered by Article12(6).

- The assessee contended that once a fee for technical service was not covered by the basic provisions of Article 12(4), which was confined to services having been rendered in the source state, there was no occasion of invoking Article 12 (6). It was submitted by the assessee that the deeming provision for Article 12(6) was confined to what was already covered by 'royalties and fees for technical services' which were neatly defined in Article 12(4) and it does not seek to extend the scope of the said basic definition. According to the assessee, it was only after 12(4) was satisfied that the deeming fiction could be invoked.

**d) Corresponding Articles of the above mentioned tax treaties as discussed in support of the contentions of the assessee:**

Article 13 of China-Pakistan Tax Treaty does not have any deeming fiction but it provided that "the term 'fees for technical services', as used in this Article, meant any consideration (including any lump sum consideration) for the provision of rendering of any managerial, technical or consultancy services by a resident of one of the contracting state in the other contracting state". It was pointed out that in China Pakistan tax treaty, there was no additional source rule, i.e. deeming fiction, for the

fees for technical services, even though there is a deeming fiction of source rule for 'royalties'. It was thus pointed out that Chinese Tax Treaties, which do not generally have 'fees for technical services' clause, have a 'place of performance test', or negation of source rule, in several tax treaties. Attention was invited to India-Israel Tax Treaty which provided, under Article 13(5), that 'fees for technical services' would be deemed to arise in a contracting state only when services were rendered in that state and the payer was resident of that state. A reference was then made to India-Saudi Arabia Tax Treaty in which a specific provision for taxability of 'fees for technical services' was altogether absent, which, according to the assessee, showed that it was not at all necessary that the source rule must extend to all payments for fees for technical services.

**Contentions of the department:**

The department contended that when payment is made to a Chinese enterprise by an Indian enterprise, the 'fee for technical services' is deemed to have arisen in India. The department also contended that in case it proceeded on the basis that such deeming provision of Article 12 (6) can only be invoked when the services by Chinese enterprise are rendered in India, this deeming clause will be rendered meaningless, as one cannot deem something which exists in reality anyway.

**Legal Analysis and Decision of the ITAT:**

a) The ITAT examined Article 12 (4) of the India-China Tax Treaty, and observed that plain reading of the treaty provisions show that under Article 12 (4) what is covered by the basic definition of the expression 'fees for technical services' is the "provision of services of managerial, technical or consultancy nature" by a resident of a Contracting State in the other Contracting State. The ITAT further stated that the expression 'provision of services' is not defined or elaborated anywhere in the tax treaty.

b) The ITAT also felt that it was important to take note of the deeming fiction under Article 12(6) of the treaty which provided that, "Royalties or fees for technical services shall be deemed to arise in a Contracting State when the payer is the Government of that Contracting State, a political subdivision, a local authority thereof or a resident of that Contracting State". In other words, irrespective of the situs of technical services having been rendered, according to this treaty provision, the fees for technical services would be deemed to have accrued in the tax jurisdiction in which person making the payment was located (i.e. India in the present case). That was a manifestation of the source rule which, in principle, required taxability of an income in the tax jurisdiction in

which it was sourced. Normally, the source of an income is the country in which person making the payment is located.

c) The ITAT further considered that there could be situations in which a payment related to business or profession being carried out in one country was being made by a resident of another country who was carrying out such business or profession in the first country. In these situations, even though the payment was not received from a resident of the first country, the true source of earning was located in the first country. Second limb of Article 12(6) considerered such situations. It provided that even when person making the payment was not resident of the other contracting state but the payment was being made by him in connection with a permanent establishment or fixed base in the other contracting state, such royalties and fees for technical services would be deemed to have accrued in the other contracting state. In such a situation, the true source jurisdiction would be that other contracting state even though the payment may be made from outside both the contracting states, and, therefore, the income was deemed to have accrued in that other contracting state.

d) The ITAT contended that whether a particular income was to be covered by the benefits of a tax treaty or not was essentially a decision at the level of the Governments and depended on several considerations all of which do not necessarily reflect sound taxation or sound economic policies. Just because India does not seek a source taxation right in tax treaty with Saudi Arabia, or because Pakistan gives up a source taxation right in tax treaty with China, it could not influence the scope of India-China Tax Treaty. It was not desirable to be influenced with what has been decided in other tax treaties entered into by the contracting states. The department contended that as regards the references to India-Israel and India-Saudi Arabia Tax Treaties, these were tax treaties with different countries and whatever was decided in these tax treaties should not influence the scope of tax treaty between India and China. The China-Pakistan Tax Treaty referred to “provision of rendering of any managerial, technical or consultancy services”, India-China Tax Treaty referred to “provision of services of managerial, technical or consultancy services”. The scope of the expression, ‘provision of services’ had to be something wider than the scope of the expression ‘provision of rendering of services’. This contrast with China Pakistan tax treaty showed that the India-China Tax Treaty intended to follow the source rule, while China Pakistan tax treaty gave up the source rule for fees for technical services. The difference between these two clauses could not be missed, and it can be clarified that while there was a deeming fiction clause in Article 12(6) of India China tax treaty, taking care of the situations in which payments were made by persons not resident in the

other contracting state, though they had a permanent establishment or fixed base in the other contracting state, there was no such corresponding clause in China that while India-China Tax Treaty followed the source rule in the matter of fees for technical services, Pakistan-China Tax Treaty did not do so. That was a conscious choice by the respective Governments, and just because China Pakistan had negotiated a bilateral tax treaty in a particular manner, it does not mean that India- China tax treaty should also be construed on the same basis. The department also noted that any other meaning being assigned to the scope of the expression, 'fees for technical services' would render Article 12(6) meaningless.

e) In addition to the above contentions, the ITAT further laid down several broad principles on interpretation of tax treaties. They are as follows:

- A tax treaty is an agreement and not taxing statute. The principles adopted in the interpretation of statutory legislation should not be applied in interpretation of treaties.
- A tax treaty should be interpreted in accordance with the ordinary meaning given to the treaty in the context and in the light of its objects and purpose.
- The provisions of the treaty should be construed in harmony with each other.
- Departure from plain meaning of the language of the treaty would be permissible whenever the context so required.
- Words should be understood with reference to the subject-matter.
- The words employed in the treaty should be given a general meaning - general to lawyers and general to layman alike.
- The meaning of the undefined terms in a tax treaty should be determined by reference to all of the relevant information and relevant context. There cannot be any residual presumption in favour of a domestic law meaning of a treaty term.

f) Thus the ITAT concluded that a literal interpretation to a tax treaty, which rendered treaty provisions unworkable and which was contrary to the clear and unambiguous scheme of the treaty, had to be avoided. The ITAT further stated that the scope of the expression 'provision for services' was much wider than the expression 'provision for rendering of services' and would cover the services even when these were not

rendered in the other contracting state, as long as these services were used in the other contracting state. The ITAT further stated that the technical services in question were covered by Article 12(4) and by the deeming fiction under Article 12(6) of the treaty. The ITAT ruled that the payment to CAIECL was covered by the scope of "fees for technical services" within the meaning assigned to that expression under Article 12 of the India-China Tax Treaty and was taxable in India as such.

g) The ITAT held that the payment was chargeable to tax under section 9 (1) (vii) as well as under Article 12 of the DTAA and tax had to be withheld at source u/s 195.

**Our Comments:**

This is going to be a significantly important decision, not only for the purposes of interpreting the scope and applicability of Article 12 of the tax treaty, but also for providing a road map on the method and manner of interpreting the tax treaties while dealing with issues of international taxation. The Tribunal rightly emphasized on the importance of adopting harmonious and literal interpretation. The Tribunal has provided several important principles that should be adopted by the judiciary in as much as it was opined by the Tribunal that the treaty partner state must try to give a harmonious interpretation. We strongly believe that this decision would be referred by many forums while dealing with intricate issues of international taxation. The conclusion of the ITAT on legal force on retrospective amendment to section 9 (1) by the Finance Act, 2010, shall surely revise many contentious issues and debate on such interpretation. The appropriateness of such interpretation shall be surely challenged before higher forum, to reach a consensus on the enforceability of retrospective amendments.

# ACCOUNTS, AUDIT & INVESTMENT

## ACCOUNTS AND AUDIT

### Standard on Auditing (SA) 620 (Revised) "Using the Work of an Auditor's Expert"

The Institute of Chartered Accountants of India (ICAI) has come out with a Standard on Auditing (SA) 620 "Using the Work of an Auditor's Expert"

**Scope of this SA**

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding the use of an individual or organization's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.

This SA does not deal with:

a) Situations where the engagement team includes a member with expertise in specialized area of accounting or auditing, which is dealt with in SA 220 (Revised); or
b) The auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements(a management's expert), which is dealt with in SA 500 (Revised)

**Objective**

The objectives of the auditor are:

a) To determine whether to use the work of an auditor's expert; and
b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.

**Effective Date**

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

## Standard on Auditing (SA) 710 (Revised) "Comparative Information—Corresponding Figures and Comparative Financial Statements"

The Institute of Chartered Accountants of India (ICAI) has come out with a Standard on Auditing (SA) 620 "Comparative Information—Corresponding Figures and Comparative Financial Statements"

### Scope of this SA

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in SA 510 (Revised) regarding opening balances also apply.

### Objective

The objectives of the auditor are:

c) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and

d) To report in accordance with the auditor's reporting responsibilities.

### Effective Date

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

## Easy Exit Scheme, 2010

In order to give an opportunity to the defunct companies for getting their names strike off from the Register of Companies, the Ministry of Corporate Affairs has decided to introduce a Scheme namely, "Easy Exit Scheme, 2010" under Section 560 of the Companies Act, 1956.

The Scheme shall come into force on the 30th May, 2010 and shall remain in force up to 31st August, 2010.

Any "defunct company" which has active status on Ministry of Corporate Affairs portal may apply under EES, 2010 in accordance with the provisions of this Scheme for getting its name strike off from the Register of Companies.

"Defunct company" means a company registered under the Companies Act, 1956 which is not carrying over any business activity or operation on or after the 1st April, 2008 and includes a company which has not raised its paid up capital as provided in sub sections (3) and (4) of section 3 of the Companies Act, 1956.

Any defunct company which is a Government Company shall submit 'No Objection Certificate' issued by the concerned Administrative Ministry or Department or State Government along with the application under this Scheme.

The purpose of the Scheme is to allow eligible companies to avail of this opportunity to exit from the Register of Companies after fulfilling the requirements laid down herewith and the decision of the Registrar of Companies in respect of striking off the name of company shall be final.

**Scheme not applicable to certain companies:**

The Scheme does not cover the following companies namely:-

a) listed companies;
b) companies registered under section 25 of the Companies Act, 1956;
c) vanishing companies;
d) companies where inspection or investigation is ordered and being carried out or yet to be taken up or where completed prosecutions arising out of such inspection or investigation are pending in the court;
e) companies where order under section 234 of the Companies Act, 1956 has been issued by the Registrar and reply thereto is pending or where prosecution if any, is pending in the court;
f) companies against which prosecution for a non compoundable offence is pending in court;
g) companies accepted public deposits which are either outstanding or the company is in default in repayment of the same;
h) company having secured loan ;
i) company having management dispute;
j) company in respect of which filing of documents have been stayed by court or Company Law Board(CLB) or Central Government or any other competent authority;
k) company having dues towards income tax or sales tax or central excise or banks and financial institutions or any other Central Government or State Government Departments or authorities or any local authorities.

## Company Law Settlement Scheme, 2010

In order to give an opportunity to the defaulting companies to enable them to make their default good by filing belated documents and to become a regular

compliant in future, the Ministry of Corporate Affairs, in exercise of the powers under Section 611(2) and 637B (b) of the Companies Act, 1956 has decided to introduce a Scheme namely, "Company Law Settlement Scheme, 2010," condoning the delay in filing documents with the Registrar, granting immunity from prosecution and charging additional fee of 25 percent of actual additional fee payable for filing belated documents under the Companies Act, 1956 and the rules made there under.

The scheme shall come into force on the 30th May, 2010 and shall remain in force up to 31st August, 2010.

Any "defaulting company" is permitted to file belated documents in accordance with the provisions of this Scheme:

Provided that any defaulting private company or public company which has not increased its paid capital up to the threshold limit of rupees one lakh and rupees five lakh respectively as provided in sub section (3) and (4) of section 3 of the Companies Act, 1956, as the case may be, shall first file its documents to increase their paid up capital up to the threshold limit under the scheme and thereafter would be allowed to file other belated documents.

"Defaulting company" means a company registered under the Companies Act, 1956 and a foreign company falling under section 591 of the Act, which has made a default in filing of documents on the due date(s) specified under the Companies Act, 1956 and rules made there under.

**Scheme not to apply to certain documents:**

l) This Scheme shall not apply to the filing of documents for incorporation or establishment of place of business in India or where specific order for condonation of delay or prior approval under the provisions of the Companies Act, 1956 is to be obtained from the Company Law Board or the Central Government or Court or any other Competent Authority is required;

m) This Scheme shall not apply to companies against which action under sub-section (5) of section 560 of the Act has been initiated by the Registrar of Companies;

## IASB Refines Standards for Other Comprehensive Income

The International Accounting Standards Board has proposed changes in the standards for presenting items under other comprehensive income.

The proposals have been jointly developed with the U.S. Financial Accounting Standards Board, which like the IASB is also seeking public comment on changes to the presentation of OCI as part of its recent financial instruments proposals.

The IASB is proposing to require that entities present their profit or loss and other comprehensive income in separate sections of a continuous statement. The IASB is also proposing to group items in OCI on the basis of whether they will eventually be "recycled" into the profit or loss section of the income statement.

The exposure draft, "Presentation of Items of Other Comprehensive Income (Proposed Amendments to IAS 1)," is open for comment until Sept. 30, 2010. It can be accessed via the "Comment on a proposal" section on www.iasb.org.

## IFRS likely to erode big companies' valuations

Large Indian companies could likely report a sharp fall in the valuation of their assets as new accounting norms prompt these companies to reassess the fair value of their units, a mandatory condition under globalized reporting standards.

Adoption of the International Financial Reporting Standards (IFRS), a modern accounting system that Indian companies have to migrate to from next year, could see local companies publicly admit to any erosion in the value of their subsidiaries or other assets.

Such instances may also be found in Indian companies that had acquired large foreign firms in the past three to four years as the global economic situation took a toll on most of these companies.

Companies like Tata Steel, Tata Motors and Hindalco which acquired big companies overseas through borrowed funds, paid additional amounts above the enterprise value for the goodwill of the foreign firms, which typically reflects the extra amount for synergy benefits, research and development and other off-balance sheet items.

These acquisitions have suffered a drop in their values due to the economic crisis. Such drop in values will now have to be reported by the companies and charged to their profit and loss accounts, which implies a run on their profitability, say auditors who deal with the financial statements of large Indian companies.

Under IFRS, companies have to do an impairment test annually to determine what the fair value of their business is today, compared to the price at which it was acquired. If there is a fall, it is charged to the profit and loss account. Apart from direct loss in business, companies also suffer from a loss in intangibles

such as R&D, intellectual property, loyal customers and customer relations. The modern accounting norms also find it impossible to value such items.

While Indian accounting norms have also pressed for reporting impairment, many Indian companies typically took refuge under a small provision in the Companies Act that allows such change in valuations to be adjusted against reserves. Also, boards of many companies need to take a call on whether any drop in valuations is typical to that industry.

Shareholders and investors in Indian companies are yet to know that there are differences between IFRS and Indian accounting norms. The Indian norms permit reversal of impairment of goodwill when certain conditions are met. This is not there under IFRS. There is also a difference in the types of assets to be tested, with the Indian GAAP including all intangible assets with a useful life of more than 10 years. Under IFRS, only intangible assets with indefinite useful life are taken.

However, it also needs to be mentioned that impairment charges do not necessarily mean a cash drain. It is only a fallout of stringent accounting rules.

## FEMA

### Reserve Bank of India revises pricing norms for foreign investments

The Reserve Bank of India has revised the pricing guidelines for foreign investments into India and attendant repatriations. The revised pricing norms which prescribe the use of 'discounted free cash flows method', instead of the earlier past performance based 'ex-CCI valuation', are likely to make investments into Indian companies more expensive.

Prior to the Amendments, any issue or transfer of unlisted shares to persons resident outside India was based on the "ex-CCI valuation" i.e. price determined in accordance with the guidelines issued by the erstwhile Controller of Capital Issues for valuation of shares in 1990. Under these guidelines (as were adopted by the RBI) the minimum price to be paid by the non-resident to the resident had to be atleast the average of the Net Asset Value ("NAV") and the Profit Earning Capacity Value ("PECV") of the company.

Since the ex-CCI valuation was driven by the past performance of the company, a need for a valuation system that took into account future performance of the company was felt, to arrive at the fair value. To that extent, the Amendments have revised the pricing norms for issuance and transfer of shares to a relatively

more progressive discounted free cash flow ("DCF") method for unlisted shares.

***Changes introduced by the Amendments:***

**1. For Listed Company:**

| Type of Issue | Previous framework | Revised Framework |
|---|---|---|
| Issue of shares | The price of shares should not have been lower than the price arrived at as per the applicable Securities and Exchange Board of India ("SEBI") guidelines. | No change. |
| Rights Issue | The offer on right basis to persons resident outside India should not have been lower than the price at which the offer is made to resident shareholders. | The offer on right basis should be at a price as determined by the company. |
| Preferential Allotment | No separate category of preferential allotment existed. Shares were issued in line with norms applicable to issuance of shares. | A new category of preferential allotment has been created. Price of shares issued on preferential allotment should not be lower than the price as applicable to transfer of shares from residents to non-residents. This pricing norm is given herein below. |

| Type of Issue | Previous framework | Revised Framework |
|---|---|---|
| Transfer by resident to non-resident (i.e. to foreign national, Non-Resident Indian ("NRI"), Foreign Institutional Investor ("FII") and incorporated non-resident entity other than erstwhile Overseas Corporate Body ("OCB")) | The transfer by way of sale should have been at a price not less than the ruling market price. | The price of shares transferred by way of sale should not be less than the price at which a preferential allotment of shares can be made under the SEBI guidelines3, as applicable, provided that the same is determined for such duration as specified therein, preceding the relevant date, which shall be the date of purchase or sale of shares ("Preferential Allotment Price"). |
| Transfer by non-resident (i.e. by incorporated non-resident entity, erstwhile OCB, foreign national, NRI, FII) to resident. | Where the shares of an Indian company were traded on stock exchange:<br>a) If the sale was effected through a merchant banker registered with the SEBI or through a stock broker registered with the stock exchange, the price should have been the prevailing market price on stock exchange;<br>b) If the transfer was other than that referred to in clause A above, the price should have been arrived at by taking the average quotations (average of daily high and low) for one week preceding the date of application with 5% variation. | The price of shares transferred by way of sale should not be more than the Preferential Allotment Price. |

| Type of Issue | Previous framework | Revised Framework |
|---|---|---|
| | Where, however, the shares were being sold by the foreign collaborator or the foreign promoter of the Indian company to the existing promoters in India with the objective of passing management control in favour of the resident promoters the proposal for sale would have been considered at a price which could be higher by up to a ceiling of 25% over the price arrived at as above.<br>Where the shares of the company were thinly traded4, the pricing norms of unlisted companies were applicable. | |

**2. <u>For Unlisted Company</u>**

| Type of Issue | Previous framework | Revised Framework |
|---|---|---|
| Issue of shares | Price of shares should not have been lower than the fair valuation arrived at by a Chartered Accountant ("CA") as per ex- CCI valuation. | Price of shares should not be lower than the fair valuation done by a SEBI registered Category-1 Merchant Banker ("MB") or a CA as per the DCF method. |
| Rights Issue | The offer on right basis to the persons resident outside India should have been at a price which is not lower than that at which the offer is made to resident shareholders. | No change. |

| Type of Issue | Previous framework | Revised Framework |
|---|---|---|
| Preferential Allotment | No separate category of preferential allotment existed. Shares were issued in line with norms applicable to issuance of shares. | A new category of preferential allotment has been created. Price of shares issued on preferential allotment should not be lower than the price as applicable to transfer of shares from residents to non-residents. This pricing norm is given herein below. |
| Transfer by resident to non-resident | The price of shares should not have been lower than the fair valuation done by a CA as per ex- CCI valuation. | The transfer of shares should be at a price not less than the fair value to be determined by a MB or a CA as per the DCF method. |

| Type of Issue | Previous framework | Revised Framework |
|---|---|---|
| Transfer by non-resident to resident. | Where the shares of an Indian company were not listed on stock exchange or were thinly traded,<br>i) if the consideration payable for the transfer did not exceed INR 2 million (approximately USD 43,850) per seller per company, at a price mutually agreed to between the seller and the buyer, based on any valuation methodology currently in vogue, on submission of a certificate from the statutory auditors of the Indian company whose shares are proposed to be transferred, regarding the valuation of the shares, and<br>ii) if the amount of consideration payable for the transfer exceeded INR 2 million per seller per company, the transfer could be at a price arrived at, at the seller's option, in any of the following manner, namely:<br>a) a price based on earning per share ("EPS") linked to the Price Earning (P/E) multiple, or a price based on the NAV linked to book value multiple, whichever was higher, or<br>b) the prevailing market price in small lots as may have been laid down by the RBI so that the entire shareholding was sold in not less than five trading days through screen based trading system, or<br>c) where the shares were not | The transfer of shares should be at a price not more than the fair value to be determined by a MB or a CA as per the DCF method. |

**Analysis and Implications:**

The key implications arising out of the Amendments are:

*Valuation restricted to DCF:*

Stipulating specific pricing parameters for valuing a company may hinder the determination of fair value of the company as these parameters vary across different sectors and industries. Typically, for arriving at fair valuation, the valuers may use various approaches like the income approach, the asset approach, the market comparables approach or a combination of them. By limiting the valuation to the DCF method, which is premised on the future cash flows of the company, the RBI has restricted the recourse to the other approaches, which may be more appropriate in certain cases. Furthermore, the DCF method may return a value which may turn out be higher than that arrived on commercial valuation.

*Rights issue pricing for listed shares:*

Pricing norms for rights issue of listed securities have been left at the discretion of the issuer company. Since, (i) generally a rights issue is offered to all the shareholders of the company at the same price, and (ii) earlier too, there were no specific pricing guidelines prescribed for a rights issue to non-residents, except that it should not have been at a price lower than the price offered to residents; the purpose of the change and reason behind differentiating between listed and unlisted shares is unclear.

*Preferential Allotment of shares:*

The Amendments have created a new category of 'preferential allotment', which did not exist earlier. Preferential allotments were treated just like issuance of shares to non-residents. However, the Amendments have stipulated that preferential allotments should be made at a price that is applicable to transfer of shares from residents to non-residents. To that extent, preferential allotments for unlisted shares will be governed by the DCF method, and for listed shares the Preferential Allotment Price may apply. As the pricing for 'preferential allotments' and issuance of shares is similar, the rationale behind creating the distinction between the two remains to be seen.

*Transfer of listed shares from residents to non-residents:*

The pricing norms for transfer of listed shares from residents to non-residents have been changed from the ruling market price to the Preferential Allotment Price. By doing so, the RBI seeks to bring the pricing norms applicable to transfer of listed shares in consistency with the SEBI pricing guidelines. This is

likely to deter manipulation of prices as Preferential Allotment Price will be less susceptible to manipulation as against the ruling market price.

*Transfer of listed shares from non-residents to residents:*

Earlier, 5% variation from the pricing norms was permitted for transfers of listed shares other than on the stock exchange. For transfer of shares to existing Indian promoters with the object of passing management control, a flexibility of 25% over the prescribed price was provided for. However, with all listed shares now being required to be transferred at not more than the Preferential Allotment Price, the flexibility to pay control premium to foreign promoters/collaborators has been withdrawn, and even such transfers have been equated with other transfers.

*Preferential Allotment Price for shares listed for less than six months:*

For transfer of shares by residents to non-residents and vice-versa, the RBI has prescribed Preferential Allotment Price. In cases where the equity shares of the issuer have been listed for a period of less than six months as on the relevant date, the SEBI guidelines mandate recomputation of price on completion of six months from the date of listing. If such recomputed price turns out to be higher than the price paid on allotment, the difference shall have to be paid by the allotees to the issuer. To that extent, dealing in shares that are listed for less than six months, may need to be structured carefully.

*Thinly traded shares:*

The RBI has removed the category of thinly traded shares. Earlier, for the purpose of pricing norms, there was a separate classification of thinly traded shares and these were clubbed with unlisted shares. But, now this distinction has been done away with and the pricing norms applicable to listed shares have been made applicable to all listed companies, irrespective of whether they are thinly traded or not. Accordingly, for shares of the company being negligibly traded, the Preferential Allotment Price may not reflect the fair value of the stock.

*Specific valuation for transfers below INR 2 million:*

All transfers now, whether below INR 2 million or not, will now be monitored. Prior to the Amendments, if the consideration payable for the transfer did not exceed INR 2 million per seller per company, the transfer could be based on any valuation methodology in vogue then. All that was required was, submission of a certificate regarding the valuation of shares from the statutory auditors of the Indian company whose shares were proposed to be transferred. But now, for

such transfers as well the DCF method has been introduced. As such, these transactions may become more expensive.

*Only one valuer for transfers of unlisted shares from non-residents to residents:*

For transfers by non-residents to residents valued above INR 2 million, the sellers were vested with multiple options. But more often than not, it was common for them to procure two independent valuations of share, one by statutory auditors of the company and the other by a CA or a MB. The reason for this was natural as the other valuation methods based on higher of the EPS (linked to the P/E multiple) or the NAV (linked to book value multiple) generally returned a lower valuation. By doing away with all the options and adopting one single DCF method for all the transfers, the RBI has made the provisions much simpler and has synced it with the entry pricing norm.

*Intangible and share premium:*

The earlier, ex-CCI valuation did not take into account the share premium to be infused by the non-resident. Neither, did it consider the intangibles while valuing the company. But, with the DCF method, the entire cash flows, including not only the share premium, but in effect, the intangibles as well, will be used for the purpose of valuation.

*Cascading effect:*

Consolidated FDI Policy mandates downstream investments by Indian companies either 'owned' or 'controlled' by non-resident entities should comply with the applicable pricing and valuation guidelines issued by the SEBI and the RBI. To that extent, the revised pricing norms will also apply to investments made by foreign owned or controlled companies in downstream companies.

***Conclusion:***

The Amendments make the pricing norms much simpler by adopting just two norms – Preferential Allotment Price for listed companies and DCF method for unlisted companies. Whilst the shift to Preferential Allotment Price is likely to deter price manipulations that could have been possible with ruling market price, it is the shift to the DCF method from the ex-CCI valuation that is likely to make a more significant impact.

Though, the DCF method may be regarded as closer to fair valuation to the extent that it takes into account the future performance as well, it may not be the best possible methodology to arrive at fair valuation. Typically, as mentioned above, a valuer would take recourse to a combination of the income approach, the assets approach or the market comparables approach to arrive at the fair

value. But DCF method will restrict the valuer from basing his valuations on the assets approach or the market comparables approach. This becomes important especially when we deal with industries with long gestation periods, or for distressed companies which have huge assets in their books but do not anticipate any future cash flows.

Implications of the Amendments may have an impact on financial investors as they may have to invest at the DCF value which is close to realizable value, or maybe even higher value, making the local companies relatively more expensive. Even though no parameters have been stipulated for calculation of the DCF value, severe discounting of cash flows to lower the floor price may not be seen favorably by the RBI, if not supported by adequate justification. Whilst the Amendments intend to ensure that the value of Indian business that gets transferred outside of India is not less than the consideration received, the implications of the Amendments on foreign investments and attendant repatriations remain to be seen.

# DISCLAIMER AND STATUTORY NOTICE

This e-publication is published by Nanubhai Desai & Co, Chartered Accountants, Mumbai, India, solely for the purposes of providing necessary information to its clients and/or professional contacts. This publication summarises the important statutory and regulatory developments. Whilst every care has been taken in the preparation of this publication, it may contain inadvertent errors for which we shall not be held responsible. It must be stressed that the information and/or authoritative conclusions provided in this publication are liable to change either through amendment to the law/regulations or through different interpretation by the authorities or for any other reason whatsoever. The information given in this publication provides a bird's eye view on the recent important select developments and should not be relied solely for the purpose of economic or financial decision. Each such decision would call for specific reference of the relevant statutes and consultation of an expert.

This e-publication should not be used or relied upon by any third party and it shall not confer any rights or remedies upon any such person. This document is a proprietary & copyrighted material created and compiled by Nanubhai Desai & Co and it should not be reproduced or circulated, whether in whole or in part, without our prior written consent. Nanubhai Desai & Co shall grant such consent at its sole discretion, upon such conditions as the circumstances may warrant. For the avoidance of doubt, we do assert ownership rights to this publication vis-a-vis any third party. Any unauthorised use, copy or dissemination of the contents of this document can lead to imitation or piracy of the proprietary material contained in this publication.

This publication is not intended for advertisement and/or for solicitation of work.